

Internal Revenue Service
memorandum

CC:TL
Br4:PPutzi

date: **FEB 1 1 1988**

to: Deputy Regional Counsel (TL) CC:SW

from: Director, Tax Litigation Division CC:TL

subject: WPT Delegation Order No. 203

In the attached memorandum dated October 6, 1987, the Windfall Profit Tax Section of the Petroleum Industry Program (EX:OP:PIP) requested the assistance of our Division in resolving an issue relating to tax administration. We informed the Windfall Profit Tax Section that we would respond to their inquiry through your office and treat the memorandum as a request for technical advice from your office. This procedure was previously approved by your office. Our response was coordinated with the Interpretative Division and that Division discussed the issue with the Windfall Profit Section.

ISSUE

How is "gross income from the property" determined for purposes of computing the net income limitation (NIL) when, under Delegation Order No. 203, the removal price for Cook Inlet crude oil removed from 1980 to 1983 is determined to have been understated?

CONCLUSION

There is no dispute as to the upward adjustment of the removal price for the prior removal year. However, some taxpayers are contending that the Service is precluded from upwardly adjusting the gross income from the property for the removal year to correspond with the removal price agreed upon under Delegation Order No. 203. We conclude, however, that the agreement with the taxpayers setting the removal price of the Cook Inlet crude oil is a mere accounting adjustment and not a receipt of money subsequent to the removal of the crude oil from the property. Consequently, the removal price agreed upon by the Service and the taxpayers should be the amount used as the gross income from the property in computing the NIL for windfall profit tax purposes.

008421

FACTS

On November 23, 1983, the Service issued Delegation Order No. 203, which provides that the wellhead price of Alaskan crude oil is a controlled issue under the jurisdiction of the Regional Commissioner, Southwest Region. Delegation Order No. 203 allows the Service to meet and deal with taxpayers and to set the removal price of Alaskan oil.

The two prevalent areas of production of Alaskan crude oil are Prudhoe Bay and Cook Inlet. The production costs of oil from Prudhoe Bay are small and only [REDACTED] was subject to the NIL from 1980 to 1983. However, [REDACTED] of the producers in Cook Inlet were subject to the NIL. The Service has met with the producers of Cook Inlet oil for 1980 to 1983, and the producers have agreed that the removal price of their crude oil for that period has been understated. Accordingly, the producers have signed agreements consenting to an increase in the removal price of the period in which the oil was removed from the premises for windfall profit tax purposes.

ANAYLSIS

IRC 4986 imposes an excise tax on the windfall profit from taxable crude oil removed from the premises during each taxable period.

Section 4988(b) generally limits the windfall profit on any barrel of crude oil to 90 percent of the net income attributable to such barrel. Net income is determined by dividing the taxable income from the property for the taxable year attributable to taxable crude oil by the number of barrels of taxable crude oil from such property taken into account for such taxable year. Taxable income from the property is determined under section 613(a).

Treas. Reg. 1.613-3(a) provides that "gross income from the property" means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into refined products prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market of field prices of the oil or gas before conversion or transportation.

GCM 38963, Windfall Profit Tax Net Income Limitation, I-218-82 (February 21, 1983) considered whether funds that are held in escrow are to be included in determining the gross income from the property for purposes of computing the NIL. GCM 38963 concludes that the normal timing rules for purposes of section 61 and section 613(a) must be incorporated into the computation of gross income from the property for purposes of section 4988.

Thus, income tax principles apply in determining when an amount must be included in the computation of gross income for purposes of the NIL. The GCM reasons that while the funds are being held in escrow the producer does not have an accession to wealth and thus there are no grounds for a current imposition of tax. Under section 61 income from the suspended account is recognized only when it is received by the producer regardless of whether the taxpayer is on the cash or accrual method of accounting; thus, the escrowed funds must be taken into income for purposes of the NIL in the year that the producer receives an unrestricted right to the funds.

In GCM 38963 the taxpayer was precluded from recomputing the NIL for the removal year because there was no accession to wealth in the removal year since the proceeds from the sale of the oil were held in escrow. The escrowed funds were included in income in the year that the taxpayer received an unrestricted right to the funds.

The NIL is computed on the basis of the gross income from the property in the removal year, which is determined in accordance with income tax principles. Gains, profits, and income are generally to be included in the gross income for the taxable year in which they are properly accrued by the taxpayer. Thus, in GCM 38963, the gross income from the property in the removal year was the amount that the taxpayer received in that year. Any additional amount received by the taxpayer in a subsequent year or any amount returned by the taxpayer in a subsequent year was properly accrued and included in or deducted from income in the year it was received or returned, respectively.

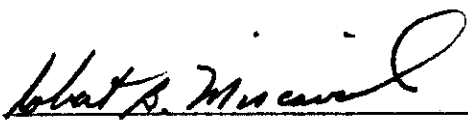
This case, however, is distinguishable from GCM 38963. In this case, the oil was shipped to refineries or there were various oil swaps so that the removal price was based on a constructive sales price determined by the producers and the Service. GCM 38963 does not preclude a recomputation of gross income from the property in the removal year in this case. The premise underlying GCM 38963 is that the gross income from the property must be included in income for tax purposes when it is properly accrued by the taxpayer. In this case, however, there was no actual receipt of cash by the taxpayer in the removal year nor receipt of additional cash in a later year. Rather, the difference in the removal price used by the taxpayers in the removal year and the removal price subsequently determined to be correct is the result of an accounting adjustment that merely redetermines the proper accrual for the initial year.

Accordingly, we believe that the gross income from the property used to determine the NIL in this case is the corrected removal price of the oil. Furthermore, we would maintain that although no income was actually received by the producers in the

removal year, the income from the oil accrued in the year the oil was removed from the premises. Under income tax principles, "income accruable in one year is not deemed income in some other year, even if it was not reported in the proper year." See Policy Holders Agency, Inc. v. Commissioner, 41 T.C. 44, 48 (1963). Thus, even though the producers understated the removal price of the oil for the removal year and did not report the full amount of gross income from the property for that year, the gross income from the property for the removal year may not be attributed to another year. Accordingly, we conclude that the gross income from the property must be recomputed for the removal year based on the removal price determined to be correct under Delegation Order No. 203.

MARLENE GROSS
Director
Tax Litigation Division

By:


ROBERT B. MISCAVICH
Senior Technician Reviewer
Branch No. 4
Tax Litigation Division

cc: WPT Section with attachment